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# In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 537

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

*v.*

INTER-MOUNTAIN LIFE INSURANCE COMPANY.

**ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.**

## BRIEF FOR RESPONDENT

### OPINION BELOW

The Board of Tax Appeals rendered no formal opinion, but on the facts as stipulated (R. 8-19) held that the reserves here in question were reserves required by law within the meaning of the tax act (R. 19). The opinion of the Circuit Court of Appeals for the Tenth Circuit is reported in 71 Fed. (2d) 962.

## JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 25, 1934 (R. 26). The jurisdiction of this Court depends upon Section 240 (a) of the Judicial Code, as amended by the act of February 13, 1925.

## QUESTION PRESENTED

Are reserves required by law to be maintained on account of portions of the valuation of coupon life insurance policies, being represented by such coupons, reserves required by law within the meaning of the 1921 tax act.

## STATUTES AND REGULATIONS INVOLVED

Section 245 (a) (2) of c. 136, 42 Stat. 227, 261, and Article 681 of Treasury Regulations 62, as quoted in the Appendix to Petitioner's brief at pages 43-45; Sections 4, 12, Ch. 3, T. 43, Revised Statutes Utah, 1933.

## STATEMENT

The facts material to the present question, as shown by the stipulation of facts (R. 8-19), briefly stated, are as follows:

Respondent a capital stock life insurance company, organized in 1911, under the laws of the state of Utah, made and sold level premium 20-Payment Life Coupon Policies—Non-Participating, during the year 1922 and prior in the states of Utah, Idaho and Arizona (R. 8). These policies contained the following provisions:

If all the premiums on the policy are paid in cash when due and at the end of twenty years the policy and all coupons attached thereto are delivered to the

company, it will merge into a full paid life policy for $14,130.00, subject to satisfactory evidence of the insurability of the insured at that time (Guaranteed Option 2); or, without medical re-examination, into a full paid life policy for $10,000.00, with an annuity of $174.40 for the life of the insured (Guaranteed Option 4); or a full paid contract for an annuity of $490.00 for at least twenty years, and as long thereafter as the insured may survive (Guaranteed Option 3); or, at the insured's option, the company will pay him $8,000.00 (Guaranteed Option 1) (R. 11). Further, if all premiums are paid in cash when due and no matured coupons have been previously surrendered to the company, at the end of fifteen years the policy will merge into a full paid life policy for $10,000.00 (R. 12). The policy carried nineteen coupons, maturing on the respective anniversaries of the policy and matured coupons could be surrendered for paid up additions to the policy, reconvertible at any time into the cash value thereof (R. 14-15).

On January 1, 1922, the reserve maintained by respondent on account of its policy obligations represented by unsurrendered matured coupons was $126,949.03, and on December 31st of that year $146,097.75 (R. 9). Four per cent (4%) of the mean thereof amounted to $5,460.94. The Commissioner did not allow this amount as a deduction from gross income, but in lieu thereof allowed interest paid on coupons surrendered during the year amounting to $897.58 (R. 9-10).

## SUMMARY OF ARGUMENT

Reserve funds required by law defined. Valuations by heads of State Insurance Departments constitute the legal reserves required by law therefor.

Insurance rights and obligations under specimen policy.

Reserve at end of twenty years with which to purchase the paid up insurance contract under Options 2, 3 and 4 amounts to $8,000.000. The accumulated reserve for the specimen policy, exclusive of coupon values, at end of twenty years amounts to $5,660.00. The remainder of the $8,000.00 reserve consists of the accumulated reserve for the coupon values. The coupon values represent parts of the reserve required by law for the specimen policy. The coupons enable the insured to surrender portions of his insurance protection, if desired, while retaining the remainder thereof. Hence the reserve for such policy is usually carried, as a matter of convenience, in two accounts or sections, one including the reserve in connection with the coupon values, which may be surrendered for the cash surrender value thereof, and the other the reserve for the remainder of the policy, the cash surrender for which can only be secured by the surrender of all then existing insurance rights under the policy. The accrued liability for such coupons does not attach until they are actually surrendered for the cash value thereof.

As the heads of the various State Insurance Departments, who make the valuations of the outstanding policies which by law constitute the reserves therefor, are the members of the National Convention of Insurance Commissioners, their resolution of 1927 that the reserves in connection with these coupons are a part of the net value reserves, paid-for basis, is practically conclusive of the question at bar.

As Congress did not change the basis of this reserve deduction in its legislation adopted since the earlier Board of Tax Appeals and Court decisions on this

question, although in considering the 1934 tax act it gave special consideration to this deduction and in certain cases changed the rate for the computation thereof, it must be assumed that its action, especially in connection with the 1934 tax act, amounted to an acceptance and ratification of the decisions referred to.

## ARGUMENT

### THE RESERVE DEDUCTION

The decision of this Court in *New York Life Insurance Company* v. *Edwards*, 271 U. S. 109, and the other cases referred to therein, have established for life insurance companies the meaning of the words "reserve funds required by law" contained in the tax acts to be a sum of money set aside or reserved from premiums, with interest accretions thereon, with which to mature or liquidate either by payment or reinsurance with other companies the future unaccrued and contingent claims arising under the provisions of the insurance contracts for which such reserve funds are maintained.

Section 245 of the 1921 Revenue Act (c. 136, 42 Stat. 227), in effect in 1922, provided for the deductions from gross income in the computation of net taxable income thereunder. Paragraph (a) (2) thereof, as far as material here, is as follows:

> "(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, x x x."

This Court in *National Life Insurance Company of Vermont* v. *United States,* 277 U. S. 508, held that the diminishing of said 4% reserve deduction was unconstitutional and that life insurance companies were entitled to the full 4% reserve deduction thereunder.

**VALUATION OF POLICIES EQUAL RESERVE FUNDS REQUIRED THEREFOR**

During and prior to the year 1922 respondent was transacting business in the States of Idaho, Utah and Arizona. During the progress of the case, the business of the Inter-Mountain Life Insurance Company was taken over by the California State Life Insurance Company, of Sacramento, California (R. 2), which is now continuing said business there under the name of California-Western States Life Insurance Company.

Section 4, Chapter 3, Title 43, Revised Statutes of Utah, 1933, regarding stock life insurance companies, as far as material here, is as follows:

> "Said capital must be unimpaired, that is, the assets of such company must equal or exceed all liabilities for losses reported, expenses, taxes and other outstanding liabilities, including the legal reserves as provided in sections 43-3-12."

Section 43-3-12, mentioned therein, as far as material here, is as follows:

> "Sec. 12. Life insurance—Valuation of policies and reserves.—For the purpose of making valuations of life insurance policies and of determining the reserves required to be maintained therefor under the provisions of this title the rate of interest assumed shall be 3½ percent per annum, and the rate of mortality shall be established by the table known as the "American Experience Table of Mortality" for policies issued after January 1, 1910; x x x."

These provisions of the Utah law have been in effect continuously during and since 1922. Respondent did not begin business until the year 1911. Similar provisions of law for the valuation of life insurance policies and reserve requirements therefor are in effect in Idaho, Arizona and California, where the business of respondent is being transacted. Under these provisions of law, the valuations by the State insurance officials of respondent's policies of insurance, represented by the specimen policy (R. 11-19), are actuarily determined as provided by said statutes and are the reserves required by law therefor. It should be noted that these valuations are exclusively confined to the life insurance content of the policies. Such reserves equal the cash surrender and loan values of the policies and are the amounts required for the reinsurance thereof.

**PROVISIONS AND CONDITIONS OF INSURANCE CONTRACT**

An examination of the face of the specimen policy discloses that it grants insurance protection for $10,000.00 during the twenty year premium paying period, and at the end thereof, if, at the insured's option, the policy and accompanying coupons are surrendered to the company intact, it will merge into a full paid insurance contract under either Option 2, 3 or 4, unless the insured prefers the surrender value instead of the continued insurance therefor (R. 11). The surrender value named in Option 1 equals the amount of the single premium consideration for either of the full paid insurance contracts provided for by Option 2, 3 or 4. The valuation or reserve for a life insurance policy must necessarily be based upon the greatest insurance risk involved under the provisions of the

contract. Therefore, in order to secure the full paid insurance contract provided for by either Option 2, 3 or 4, this reserve at the end of the twenty year period must amount to $8,000.00, the surrender value provided for by Option 1.

The table in the specimen policy giving cash or loan values, exclusive of coupon values, shows that the cash surrender value at the end of the twenty year period for each $1,000.00 of insurance is $566.00 (R. 15). Hence, on this basis, the cash surrender value, or reserve, of the specimen policy for $10,000.00 at the end of the twentieth year amounts to only $5,660.00, while the surrender value, or reserve, of the specimen policy at the end of the twentieth year, as shown by Option 1, amounts to $8,000.00. The difference between these amounts must, therefore, consist of that part of the reserve which has accumulated on the coupon values until the end of the twentieth year.

From the above it will be seen that the values set out in the respective coupons are portions of the amounts which have been actuarily determined, set aside and reserved from the second and successive premium payments, in order, with the accumulations thereon, to provide the funds necessary to purchase the amount of paid up insurance contracted for at the end of the premium paying period; that is, the surrender value of the policy at that time.

In this connection, attention is called to the fact that the accumulations on these coupon values are necessarily determined in exactly the same manner as the accumulations on the other section of the reserve. The coupons attached to these policies form a very clever and ingenious device by means of which, if desired, the insured can surrender a part of his

insurance rights under the policy without at the same time abandoning his entire insurance protection thereunder. For this reason, we understand, that companies writing this class of policy usually carry two reserve accounts therefor, in order to simplify their bookkeeping and thus segregate the so-called coupon reserve section from the remainder of the reserve account. Thus when matured coupons are surrendered proper entries can be made therefor without disturbing the other section of the reserve account, unless at the same time the entire policy is surrendered. In regard to these coupons, it will be noted that they do not become accrued liabilities until they are presented for payment, which necessarily involves their surrender and the concurrent surrender of a part of the insurance protection of the insured under the policy, thus giving rise to such liability, the exact situation for all reserves. When a life policy is surrendered in toto, there being no further necessity for the maintenance of a reserve therefor, such reserve then becomes the surrender value of the policy. . .

**RESOLUTION OF NATIONAL CONVENTION OF INSURANCE COMMISSIONERS**

As under the provisions of the State laws requiring the annual valuation of life insurance policies by the State Insurance Departments, which valuations, also by statute, are made the reserves required by law therefor, the resolution of the National Convention of Insurance Commissioners, adopted in 1927, appears to be practically conclusive of the question at bar. This resolution, as quoted in the opinion of the Board of Tax Appeals in the *Standard Life Insurance Company* case, 13 B. T. A. 13, 26, is as follows:

"There has been some lack of uniformity among some companies which write so-called 'coupon policies' in the manner of reporting matured coupons which are not cashed by the policyholder as they become due but are permitted to accumulate and remain with the company to apply to the reduction of the premium paying period, the purchase of additional insurance, or some similar guaranteed policy benefit. The proceeds of such matured coupons are, clearly, held by such companies to meet guaranteed policy obligations at maturity. They are therefore reserves required by law and should be included in the reserves of the company reported above Line Seven on the Convention blank."

The reserves reported above Line Seven on the Convention annual statement blank to which this resolution refers are the "Net Reserve—Paid For Basis." This resolution is directly applicable in respondent's case, in view of the fully paid up provisions of the specimen policy (R. 11-12), and the further fact that for 1922 it did not include the reserves held by it in connection with matured and unsurrendered coupons as a part of its net reserve, paid-for basis, but reported them elsewhere in its annual statement. This resolution clearly shows, in the opinion of the Insurance Commissioners, who are the heads of the various State Insurance Departments and who determine by their valuations of policies the amount of reserves required by law therefor, that these reserves, in connection with unsurrendered coupons which had matured, were a part of the net reserves, paid-for basis, required by law for such policies.

## PREVIOUS DECISIONS OF THIS QUESTION RATIFIED BY 1932 AND 1934 TAX ACTS

Since the decision of the Board of Tax Appeals in the *Standard Life Insurance Company* case, *supra*, affirmed by the Circuit Court of Appeals in 47 Fed. (2d) 218, and other similar decisions, Congress has had the revenue laws of 1932 and 1934 under consideration and has made no change in the basis for the deduction from gross income on account of reserve funds, although while the 1934 tax act was under consideration it gave special attention to this deduction and did provide that in certain cases the rate for the computation of such deduction should be reduced. Therefore, it must be assumed that Congress thereby accepted and ratified the decision of the Board of Tax Appeals, as affirmed in *Commissioner* v. *Standard Life Insurance Company, supra,* and the subsequent Board and Court decisions prior to the passage of the 1934 revenue act, as to the reserves to be used as the basis for the computation of this reserve deduction.

In support of and supplemental to the reasoning herein, see—*Standard Life Insurance Company of America* v. *Commissioner,* 13 B. T. A. 13, on appeal 47 Fed. (2d) 218; *Commissioner* v. *Western Union Life Insurance Company,* 61 Fed. (2d) 207, and *Commissioner* v. *Great American Life Insurance Company,* 70 Fed. (2d) 133.

## CERTIFICATE AND AFFIDAVIT CONCERNING RESERVE REQUIREMENTS FOR SPECIMEN POLICY

For the information of the Court, we have included in the appendix a certificate of the Insurance Commissioner for the State of California, regarding the

valuation of respondent's coupon policies under the California statutes, and the inclusion of the so-called coupon reserves as a part of the total reserves for such policies.

For a like reason, we have also included in the appendix the affidavit of Marcus Gunn, formerly Actuary for respondent and now Associate Actuary of its successor, the California-Western States Life Insurance Company, setting up the reserves required by the California law for the specimen policy herein (R. 11-19).

## CONCLUSION

For all of the foregoing reasons, it is submitted that the opinion of the Circuit Court of Appeals here under review should be affirmed.

Respectfully submitted,

STEPHEN W. DOWNEY,
A. R. SERVEN,
*Attorneys for Respondent.*

## APPENDIX

### STATE OF CALIFORNIA
### DEPARTMENT OF INVESTMENT
### DIVISION OF INSURANCE
### SAN FRANCISCO

I, E. Forrest Mitchell, Insurance Commissioner of the State of California, do hereby certify that under the provisions of Section 629 of the Political Code of the State of California, covering valuation of life insurance policies, this Division requires the inclusion of so-called coupon reserves on policies such as the coupon policies of the Intermountain Life Insurance Company, reinsured by the California-Western States Life Insurance Company, as a part of the total reserve on coupon policies.

IN WITNESS WHEREOF I have hereunto set my hand and affixed my official seal this 2nd day of February, 1935.

E. Forrest Mitchell,
*Insurance Commissioner.*
Sgd. by Mae Barr Long,
*Deputy.*

[SEAL]

Affidavit Regarding Terminal Reserves

Sacramento, California,
February 2, 1935.

To whom it may concern:

This is to certify that the following table sets forth the exa t reserves by policy years which must be maintained by the Life Insurance Company in order to comply with the requirements of the California Laws

for valuation of life insurance policies as defined in Section 629 of the Political Code of California, for the Twenty Payment Life Coupon Policy of the Inter-Mountain Life Insurance Company, of the face amount of $10,000, issued at Age 35:

*Terminal Reserves*

| End of Policy Year | "A" If reduced premiums are paid | "B" Coupon Section of Term. Reserve | "C" If full premiums are paid * |
|---|---|---|---|
| 1 | 00.00 | 0.00 | 0.00 |
| 2 | 210.10 | 81.70 | 291.80 |
| 3 | 428.00 | 167.10 | 595.10 |
| 4 | 654.10 | 256.40 | 910.50 |
| 5 | 888.70 | 349.70 | 1238.40 |
| 6 | 1132.00 | 447.20 | 1579.20 |
| 7 | 1384.40 | 549.00 | 1933.40 |
| 8 | 1646.30 | 655.20 | 2301.50 |
| 9 | 1917.90 | 766.20 | 2684.10 |
| 10 | 2199.60 | 881.80 | 3081.40 |
| 11 | 2491.80 | 1002.40 | 3494.20 |
| 12 | 2794.70 | 1128.10 | 3922.80 |
| 13 | 3108.90 | 1259.10 | 4368.00 |
| 14 | 3434.60 | 1395.60 | 4830.20 |
| 15 | 3772.20 | 1537.80 | 5310.00 |
| 16 | 4122.30 | 1685.80 | 5808.10 |
| 17 | 4485.40 | 1839.90 | 6325.30 |
| 18 | 4862.30 | 2000.30 | 6862.60 |
| 19 | 5254.00 | 2167.20 | 7421.20 |
| 20 | 5660.00 | 2340.00 | 8000.00 |

Col. "A" plus Col. "B" equals Col. "C"

* NOTE—Column "C" shows the total reserve for the end of each policy year, which is required to be maintained by California Valuation Law for the above

described policy, when the full premium named in the consideration clause of the policy, $420.90 has been paid each year, the insured not having availed himself of the option of paying the premiums reduced by coupon amounts, and not having withdrawn that portion of the policy value represented by coupons. This reserve makes possible the granting of Options 1, 2, 3, and 4 which are available at the end of the 20th policy year.

MARCUS GUNN.

MARCUS GUNN, Fellow American Institute of Actuaries, Associate Actuary California-Western States Life Insurance Company, Sacramento, California.

[SEAL]

Sworn to and subscribed before me this 2nd day of February, 1935.

MARGARET E. DOHERTY,
*Notary Public.*